

September 3, 2008

CDM Executive Board
UNFCCC Secretariat
Martin Luther King Strasse 8
P.O.Box 260124
D-53153
Germany

Dear Mr. Sethi,

I write to you on behalf of the International Emissions Trading Association (IETA) and in response to the invitation by the Executive Board at EB 41 to comment on the “**Proposal for an enhanced barrier test for project activities that have potentially high profitability without CER revenues.**”

While IETA understands that the development of this test is motivated by genuine concern that the environmental integrity of the Mechanism is threatened by non-additional projects securing registration, IETA does not believe that an enhanced barrier test is an effective means of addressing this concern. First and foremost, IETA would like to reiterate that such a test runs counter to the Marrakech Accords, which stipulates that the reduction of greenhouse gases below those that would have occurred in the absence of the CDM project activity is the key determinant of additionality, not the profitability of a project. Moreover, it is IETA’s strong opinion that attempting to identify the *potential* for profitability, *ex ante*, is an extremely impractical endeavor and is likely to erroneously restrict truly additional projects, thereby discouraging further project investment and significantly lowering the environmental benefit of the CDM. Profitability does not equate to non-additionality. In fact, it is a principle of the market that the pursuit of profit will lead to additionality: entrepreneurs will undertake projects that would not have been undertaken if the prospect of profit did not exist. IETA suggests that the Board move towards the increased usage of standardized baselines,

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rather than complex, non-objective tests, to ensure the environmental integrity of the CDM.

You will find these positions much elaborated below, where IETA both addresses the Board's concern about the additionality of highly profitable CDM projects, in general, as well as explains the difficulty of creating a test that is capable of identifying highly profitable projects *ex ante*.

Limiting Additionality to Financial Additionality

To begin, IETA would like to reiterate our enduring concerns about the Board's tendency to make the determination of additionality more dependent on financial additionality, a move that directly contradicts the Marrakech Accords (i.e. 17/CP.7. Para 43), which states, "A CDM project activity is additional if anthropogenic emissions of greenhouse gases by sources are reduced below those that would have occurred in the absence of the registered CDM project activity." Requiring financial additionality was explicitly debated and rejected at Marrakech, and the agreed definition makes it clear that profitability is not, *per se*, a determinant of additionality.

Further, subsequent decisions by the Parties have reiterated the 17/CP.7. Para 43 decision, and given guidance to the CDM EB making it clear that means for demonstration of additionality should be expanded, rather than narrowed. For example, in 2005, para 28 of Decision 7/CMP.1 confirmed that the use of the "tool for the demonstration and assessment of additionality" is not mandatory for project participants and that in all cases the project participants may propose alternative methods to demonstrate additionality for consideration by the Executive Board, including those cases where the "tool for the demonstration and assessment of additionality" is attached to an approved methodology. Notwithstanding this clear guidance, the CDM EB is considering explicitly narrowing the scope of the Additionality Tool, and *implicitly* narrowing the operational definition of additionality to financial additionality.



Moreover, the CDM EB recognizes that there are many highly profitable potential CDM projects that do not get developed; a key example being end-use energy efficiency. In fact, the enhanced barrier proposal does not include this activity precisely because it is widely recognized that there is a market failure in terms of end-use energy efficiency and that CDM, along with other actions (i.e. education) and incentives, can spur highly profitable investment that would not otherwise occur.

The Role of Financial Attractiveness

The critical issue that IETA would like to express is that expected profitability is not the only determinant of an investment decision, but that it may be (and should be *allowed to be*) a very important one, without which a CDM project would never be developed.

Indeed, the overall financial outline of a project activity *must be* attractive, and *potentially highly* attractive, so that project developers and financiers are willing to assume the risks specific to individual project activities as well as those inherent in the CDM registration and issuance process. Project-specific risks— related to host country, technology employed, financing structure, and project partners— often prevent project implementation, even in the case of potentially high financial attractiveness. Without further incentives, such as CERs issuance and the increased visibility that comes with being associated with the CDM, many highly profitable projects would never be developed.

Placing Constraints on Commercial Profitability

Finally, the right to decide the constraints of commercial profitability, until now, has always remained with Party governments, not the CDM EB. Indeed, some Parties have already chosen to tax the revenues of highly profitable projects (e.g. Vietnam and China) and recycle them back into the emission reduction activities of the country. It is IETA's opinion that this prerogative should remain with host governments, except where due processes of international law have established a fiscal or quasi-fiscal instrument.



The Difficulties of Identifying *Potentially* Highly Profitable Projects

In addition to IETA's general disagreement with the move towards limiting the determination of additionality to financial additionality, we would also like to point out the impracticality of identifying criteria by which to determine if projects *will* be highly profitable. Outlined below are just a few of the complex issues that combine to determine the ultimate profitability of a project. This discussion only strengthens our claim that designing an enhanced barrier test aimed at potentially highly profitable projects is a misguided pursuit.

(1) National discrepancies in inflation rates/interest rates/exchange rates

Inflation and interest rates differ from one country to another and in reaction to varying exchange rates and country international credit ratings. These inflation and interest rates have a strong impact on the profitability of a project, which is often not easy to identify *ex ante*. An extreme example of this has occurred in Zimbabwe, where a 1,000,000% per annum IRR today would still not mean the project was very profitable.

(2) Commodity Market Risk (Volatility)

The profitability of many CDM project activities is also dependent on highly volatile commodity prices. Any project, upon inception, makes a number of assumptions about what will be the future price of its main input, e.g. coal or steel, as well as the prices that it will be able to charge for output, e.g. electricity.

In order to stifle the risk associated with these "bets" on future prices, firms would typically "hedge" these risks by acquiring expensive coverages, e.g. futures contracts or options. The high-costs of hedging reduce the profitability of a project to a degree that can be unknown *ex ante*, because the effectiveness of the hedging strategy is unknown.



With the current rise in commodity prices, however, the ability of using hedging strategies to minimize firm exposure to the risks associated with commodity-price volatility is becoming exponentially more costly than in previous years. Costs are now so high that firms are finding it difficult to hedge beyond a three-year horizon, even on projects that last for decades. Long-term investments today, therefore, tend to be unprotected from commodity price volatility, making the profitability of these types of projects even more unpredictable.

(3) Political Risks

The profitability of many CDM project activities is also dependent the political and institutional stability of a country. Even CDM projects developed in areas considered to be relatively stable (e.g. Kenya) may lose profitability quickly as a result of political or macro-economic developments in a country.

(4) Effects of Governmental Interventionism on Energy Sector Projects

The profitability of many projects is ultimately determined by government energy pricing policies, such as subsidies and price controls on inflows and outflows. Such intervention is a factor entirely exogenous to the project itself.

In developing countries it is common for governments to either set or strongly influence energy prices. Profitability can be undermined by political decisions to freeze prices as well as by many countries' requirement that utilities produce electricity regardless of cost (as has recently occurred in South Africa during a time of severe electricity shortage). Similarly, in the past several months China has, successively, frozen the price of power, then the price of coal, and finally returned to freeze the price of power once again. The frequency and unpredictability of such intervention indicates that all sectors where pricing capacities are government-constrained would be impossible to test for high profitability *ex ante*.



(5) Financing techniques

Finally, the financial techniques implemented for a project can create huge swings in a project's profitability, regardless of the inclusion of CERs. Namely, the ratio of debt to equity in an investment (also referred to as a project's financial leverage) has significant, though un-predictable effects on a project's profitability. The higher the percentage of financing through a creditor's funds (debt) as opposed to financing through the project owner's own funds (equity), the higher the level of financial risk due to increased volatility of profits.

To explain, utilizing high levels of debt and long-term finance amplifies the potential gain from an investment project, but it also increases the potential loss. CDM projects with a high debt/equity ratio may prove to be extremely profitable, or they may not. There is no way, therefore, to determine the final profitability of a project *ex ante*. See the examples in the box below for further explanation.

CASE A: 11% return on equity **CASE B: 8% return on equity**
Cost of debt for both cases: 9% per annum

Scenario 1. 100% of project financed through equity (no debt financing)

CASE A: Return on equity (ROE) = 11% profit per annum

CASE B: ROE = 8% profit per annum

Scenario 2. 66 debt / 33 equity financing,
66 (amount of debt) x 9% (cost of debt) = 5.94

CASE A: ROE = 11 (% return) – 5.94 (% cost of debt) = 5.06,
So, for an equity of 33, the profit will be 5.06/33 or 15.3% profit per annum

CASE B: ROE = 8 (% return) – 5.94 (% cost of debt) = 2.06
So, for an equity of 33, the profit will be 2.06/33 or,
for the same project financed in a different way, 6.24% profit per annum

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Scenario 3. 80 debt / 20 equity financing,
 $80 \text{ (amount of debt)} \times 9\% \text{ (cost of debt)} = 7.2$

CASE A: $\text{ROE} = 11 \text{ (\% return)} - 7.2 \text{ (\% cost of debt)} = 3.8$,
So, for an equity of 20, the profit will be $3.8/20$ or **19% profit per annum**

CASE B: $\text{ROE} = 8 - 7.2 = 0.8$
So, for an equity of 20, the profit will be $0.8/20$ or,
for the same project financed in a different way, **4% profit per annum**

Results: Depending on financing techniques, CASE A provides a profitability anywhere between 11% and 19% per annum; whereas CASE B provides a profitability anywhere between 4% and 8%. The range of these outcomes explains how financing techniques, combined with the return on equity, greatly impact the profitability of projects, regardless of CER revenue.

IETA's Suggestions

For all of the reasons outlined above, IETA believes that endeavoring to identify highly profitable project activities *ex ante* is almost impossible, and certainly not a useful way by which to go about ensuring the environmental integrity of the CDM. Given this understanding, the following three suggestions are put forth:

1. At a Minimum, Multiple Tests are Required

The previous section highlighted the impact that country-specific conditions have on the profitability of projects. The board should also be reminded that the ability to prove barriers differs by project type and country and that CDM project activities are implemented in countries where the data required to prove barriers is often difficult or impossible to attain. For these reasons, IETA believes that, if the Board continues down the path of developing an enhanced barrier test, this test must be developed on a country-by-country and project type-by-project type basis. Such an approach is the only way to ensure that such a test does not restrict a large number of excellent projects from CDM financing, thereby decreasing the environmental benefit of the mechanism.



2. A More Appropriate and Workable Solution: Standardized Baselines

Given the numerous problems related to the development of an enhanced barrier test for highly profitable projects (as well as for *multiple* tests), IETA suggests, in lieu of the approach taken in the draft proposal, that the Board consider the increased usage of standardized baselines as a means of ensuring additionality and identifying appropriate crediting baselines for project types around which concerns have arisen. The Board has already embraced this approach with its approval of methodology ACM0013, “Consolidated baseline and monitoring methodology for new grid connected fossil fuel power plants using a less GHG intensive technology.” Taking this approach will allow the Board to bypass any messy and arbitrary attempts to identify projects with the *potential* of being highly profitable and narrow in on what really matters for the CDM, the additionality of projects and the over-all environmental integrity of the mechanism.

3. Grace Period is Vital

Whatever decision the Board takes on this issue, it is essential that any new test or approach towards addressing additionality and/or the environmental integrity of the CDM must be accompanied by a grace period of at least one year from the date of its acceptance by the Board. Such a grace period is vital if the Board is to avoid jeopardizing the fate of projects already submitted for validation.

In closing, IETA appreciates the chance to share our comments and hope that our suggestions provide a firm base upon which you may continue your discussions on the issue.

Henry Derwent
President